RB-2001-04 Guidance on Loans Secured by Readily Marketable Collateral

BACKGROUND

The Department supports credit union involvement in lending activities that are legal, creditworthy and consistent with sound credit union principles; such activities include extensions of credit secured by readily marketable collateral. However, due to the more complicated nature and level of risk associated with such loans, it is necessary that the credit union's board of directors and management ensure that sound policies and procedures are in place to govern their involvement in this lending area.

Credit unions should recognize the additional risk inherent in this type of lending and determine if these risks are acceptable and controllable given the credit union's staff, financial condition, size, and level of capital. Credit unions that engage in this type of lending must have board-approved policies and procedures, as well as internal controls that identify and control these additional risks.

PURPOSE

The purpose of this Bulletin is to provide a general overview of the special considerations related to loans secured by readily marketable collateral.

DEFINITION

For the purposes of this Bulletin, readily marketable collateral must be financial instruments or bullion that can be promptly sold under ordinary market conditions at a fair

market value determined by reliable and continuously available price quotations, based upon actual transactions on an auction or similarly available daily bid and ask price market. Financial instruments are stocks, bonds, notes, and debentures traded on a national securities exchange, over-the-counter margin stocks as defined in Regulation U (12 CFR, Sections 221.1 et seq), negotiable certificates of deposits, and shares in a money market mutual fund where credit unions may perfect a security interest. This does not include individual mortgages.

RISKS

The primary risk associated with loans secured by readily marketable collateral is that the value of the collateral may decline below the outstanding loan balance. A credit union should ensure that it monitors the market value of any financial instrument held as collateral and takes appropriate action if the value of the financial instrument subsequently declines below a predetermined maximum loan-to-value ratio. Such action may include, but is not limited to, requiring the member to provide additional collateral or reduce the loan balance.

Other risks that should be considered by management include the limited market for closely held or restricted stocks; the price volatility of stocks of smaller or less stable companies; and fluctuations in the value of debt securities as a result of changes in market interest rates.

BOARD-APPROVED WRITTEN POLICIES

In accordance with sound business practices and the requirements of Commission Rule 91.701, before engaging in lending secured by readily marketable collateral, a credit union must establish written policies approved by the board of directors that address the following, as applicable:

1. Types of financial instruments acceptable for collateral

- purposes and the maximum loan value for each type of instrument;
- 2. Procedures for safekeeping the financial instruments pledged as collateral;
- 3. Documentation requirements to establish the credit union's security interest and right to redeem the collateral in the event of default;
- 4. Procedures for monitoring the value of the financial instruments during the life of the loan, and specific actions that will be taken if the loan balance exceeds the maximum loan value requirement; and
- 5. Compliance with Federal Reserve Board Regulation U.

FEDERAL RESERVE BOARD REGULATION U

The Federal Reserve Board (FRB) issued Regulation U pursuant to the Securities Exchange Act of 1934 to prevent the excessive use of credit when purchasing or carrying margin securities. The regulation sets out certain requirements for credit unions that extend or maintain credit secured directly or indirectly by margin securities. The reporting requirements and lending restrictions of Regulation U apply only to credit unions required to register.

Registration

Any credit union that extents credit, directly or indirectly secured by margin securities, and that meets either of the following two requirements must register with the Federal Reserve Board:

- Extends margin-stock-secured credit in any calendar quarter equaling \$200,000 or more, or
- Maintains margin-stock-secured credit outstanding at any time during a calendar quarter totaling \$500,000 or more.

Margin stock consists primarily of equity securities registered on a national securities exchange, such as the New

York Stock Exchange or the American Stock Exchange; any overthe-counter security trading in the National Market System; any debt security convertible into a margin stock; and most mutual funds.

Lending Restrictions

Regulation U prohibits credit unions from extending credit in excess of the maximum loan value if the purpose of the credit is to buy or carry margin securities. Credit of this nature is known as a "purpose loan." The maximum loan value of any margin security for a purpose loan is 50 percent of its current market value.

Each purpose credit extended to a member is also subject to the "single credit rule." All purpose credits extended to a member are considered a single credit. Compliance includes aggregation of all collateral.

If the proceeds of a margin-stock-secured loan are for a purpose other than to purchase or carry margin stock, the maximum loan value is the good-faith basis, not to exceed 100 percent of the current fair market value of the collateral. Good-faith basis is the amount that a credit union would be willing to lend without regard to any other assets of the member. Credits of this nature are "non-purpose loans."

The Regulation allows credit unions to permit any withdrawal or substitution of cash or collateral by the member if the withdrawal or substitution would not cause the credit to exceed the maximum loan value of the collateral or increase the amount by which the credit exceeds the maximum loan value of the collateral.

Reporting and Regulatory Requirements

Registered credit unions must file an annual report with the Federal Reserve Bank showing their lending activities secured

by margin stock. The report contains the amount of such credit outstanding and extended during a calendar year. Registered credit unions file this report along with a copy of their balance sheet.

Federal Reserve Form FR G-3 entitled "Statement of Purpose for an Extension of Credit Secured by Margin Securities by a Person Subject to Registration Under Regulation U" must also be completed for each credit secured by margin securities. Both the member and the credit union complete the purpose statement for every margin-stock-secured loan extended. The form must be maintained by the credit unions for three years after the credit is paid-off.

Deregistration

A registered credit union may apply to terminate its registration if the credit union has not, during the preceding six calendar months, had more than \$200,000 of marginstock-secured credit outstanding. A credit union is deregistered upon approval of the Federal Reserve Board.

CONCLUSIONS

Managing the risks inherent in loans secured by readily marketable collateral is a complex task. Management must exercise the risk selection, underwriting, credit administration, and portfolio management discipline required to safely manage the risks associated with lending in general. They must also exercise additional diligence to properly identify, measure, and control the unique risks associated with lending secured by readily marketable collateral.